AR31

1977
ANNUAL REPORT

CANADIAN HYDROCARBONS LIMITED

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CANADIAN HYDROCARBONS LIMITED

1977 Annual Report

FINANCIAL AND OPERATING HIGHLIGHTS

FINANCIAL

	1977	1976
Net earnings	**$ 5,936,000**	$ 5,341,000
Funds from operations (excluding depletion on limited term oil and gas leases)	**13,461,000**	13,119,000
Gross revenue	**272,945,000**	262,656,000
Dividends on common shares	**1,284,000**	1,282,000
Per common share:		
Net earnings	**1.04**	.93
Cash dividends		
March	**.125**	.125
September	**.125**	.125
Long term debt	**54,404,000**	64,204,000
Total assets	**234,896,000**	217,726,000
Average number of common shares outstanding	**5,137,631**	5,129,680

OPERATING

	1977	1976
Propane and butane — gallonage	**210,469,000**	198,041,000
Gasoline and other petroleum products — gallonage	**222,343,000**	237,691,000
Natural gas — Mcf	**18,164,000**	18,342,000
Electricity — kwh	**61,201,000**	57,555,000
Number of employees	**2,094**	2,529
Number of common shareholders	**2,608**	2,814

Gallonage figures are expressed in terms of Canadian gallons.

The Company, Canadian Hydrocarbons Limited, operating through subsidiaries is principally engaged in the marketing of propane, gasoline and light and residual oils; refining of petroleum products; operation of natural gas utilities; operation of an electrical utility; pipe and steel fabrication; interests in producing oil and natural gas properties; and exploration for and development of oil, natural gas and other minerals.

Contents

Annual Meeting

The Annual Meeting of the Company will be held at The Winnipeg Inn. Winnipeg, Manitoba at 10 a.m. May 19, 1978.

Annual Report on Form 10-K

The SEC Annual Report Form 10-K for the year ended December 31, 1977 will be provided by mail upon receipt of a written request from any person who is a beneficial owner of Canadian Hydrocarbons Limited's common stock.

Such written requests should be directed: J. E. Carstairs, Secretary, Canadian Hydrocarbons Limited, Inter-City Gas Building, 1800 444 St. Mary Ave., Winnipeg, Manitoba R3C 3T7.

R. G. GRAHAM
Chairman of the Board
and President

REPORT TO THE SHAREHOLDERS

Net earnings for the year ended December 31, 1977 were $5,936,000, an increase of 11% from the $5,341,000 earned in 1976. This resulted in earnings per common share for the year of $1.04 compared with 93¢ per share in 1976. Revenue in 1977 was $272,945,000, compared with $262,656,000 in 1976.

Results of the operations of your company's forest products division have been eliminated from the financial results as the operation of this division has been discontinued. The forest products division, (acquired in 1974) located in Oregon, was involved in the wholesale trading of plywood and lumber and in the manufacturing of plywood. The forest products division has continually experienced substantial losses and is not compatible with the company's commitment to the energy industries. The net earnings presented in this report include the loss for the current year in the forest products division, plus a provision for estimated losses resulting from the discontinuance of this operation. Without such losses, net earnings would have been $7,845,000 in 1977 and $6,505,000 in 1976 and earnings per common share $1.42 in 1977 and $1.15 in 1976.

Among the company's principal activities, the distribution of petroleum products contributed an increase of $2,780,000 to 1977 operating

NET EARNINGS PER COMMON SHARE
DOLLARS

profit. This 22% increase, realized on sales volumes marginally lower than the previous year, reflects the results of a major operational improvement program which included the centralization of management control and the relocation of administrative staff now head-quartered in the Inter-City Gas Building in Winnipeg.

Operations of the company's natural gas utilities in Manitoba, Alberta and British Columbia produced approximately the same contribution to operating profit as in 1976. The revenue increase of 32% is a reflection of higher gas purchase prices without significant contribution to operating profit.

The company participates in petroleum and natural gas exploration primarily through its affiliate, Canadian Homestead Oils Limited. Earnings attributable to the company's investment in Canadian Homestead increased by 66% over 1976. The operations of Canadian Homestead are described in the following pages of this report.

On December 23, 1977 Inter-City Gas Limited, which now owns 49.7% of Canadian Hydrocarbons Limited filed a preliminary prospectus with the United States Securities and Exchange Commission outlining an exchange offer for the balance of the outstanding shares of the company. When approval has been received from this governmental agency and when Canadian regulatory commissions have completed their review, the exchange offer can proceed. Approval is anticipated by mid-year.

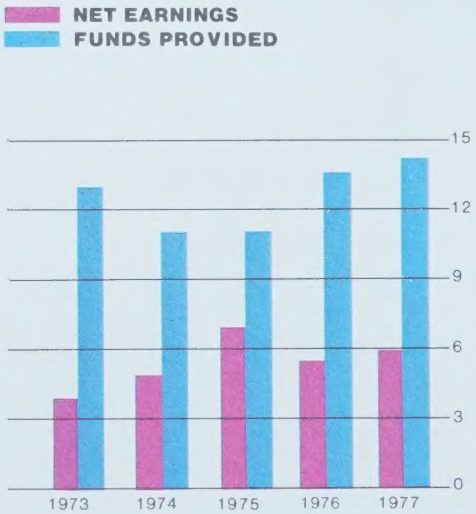
The notes to the financial statements contained in this report refer to significant transactions relative to the company's investment in Inter-City Gas Limited.

PETROLEUM PRODUCTS

Through subsidiaries, the company distributes petroleum products, primarily propane, through 211 outlets in all Canadian provinces from British Columbia to Quebec and in 194 locations in five north-western American states.

Sales are made through company and dealer operated retail outlets and to wholesale distributors.

NET EARNINGS AND FUNDS PROVIDED
(excluding depletion on limited term leases)
MILLIONS OF DOLLARS



Petroleum product and merchandise sales in Canada were as follows:

	1977	1976
Propane	$ 76,765	$ 68,992
Gasoline.	39,563	43,849
Light & residual oils	4,465	10,401
Merchandise.	15,483	14,533
	$136,276	$137,775

The increase in propane revenues is due primarily to increased demand for grain drying and new industrial accounts. During 1977 the company sold unprofitable retail gasoline outlets in Ontario and Quebec and a small refinery in Saskatchewan.

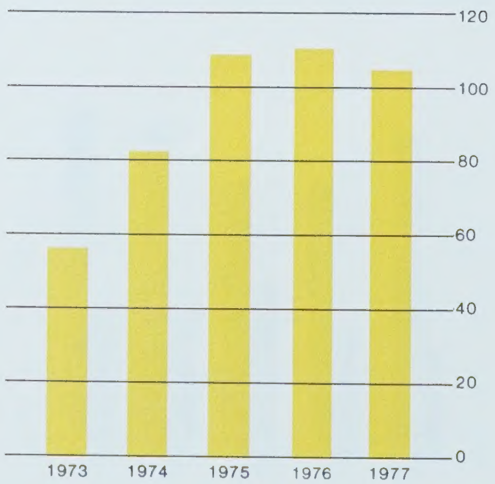
The propane distribution organization in Canada underwent a major operational improvement program in 1977 and operating costs were reduced substantially. This program, together with the increase in propane revenues and the elimination of marginal operations resulted in the increased contribution to operating profits of $2,355,000 from $8,868,000 in 1976 to $11,223,000 in 1977.

Petroleum products and merchandise sales in the United States were as follows:

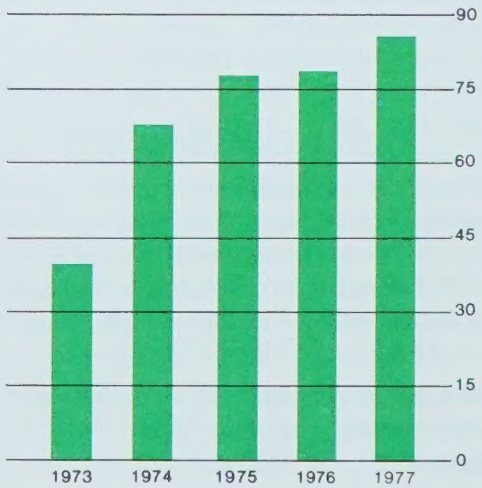
	1977	1976
Propane	$ 9,900	$ 8,537
Gasoline.	38,540	33,625
Light & residual oils	22,313	21,254
Merchandise.	5,330	4,353
	$ 76,083	$ 67,769

Petroleum product and merchandise sales increased by 12%, however, the volume of

GASOLINE, FUEL OILS AND OTHER REFINED PRODUCTS REVENUE
MILLIONS OF DOLLARS



PROPANE REVENUE
MILLIONS OF DOLLARS



product sold in the United States was reduced due to the planned phase-out of a small crude oil refinery at Kevin, Montana. Gross profits increased through more selective marketing with contribution to operating profits increasing to $4,261,000 in 1977 from $3,836,000 in 1976.

The two remaining refineries in the United States are presently undergoing a major modification program in order to produce a more profitable higher octane product line. In 1977 these two refineries operated at 80% of their aggregate capacity of 10,000 barrels per day.

The natural gas processing plants in Montana and Alberta produced higher operating profits due to both increased prices and higher production levels.

UTILITY OPERATION

The company provides natural gas utility service to 94 communities and 26 farm areas in Manitoba, Alberta and in British Columbia, plus electric utility service in Yellowknife, N.W.T.

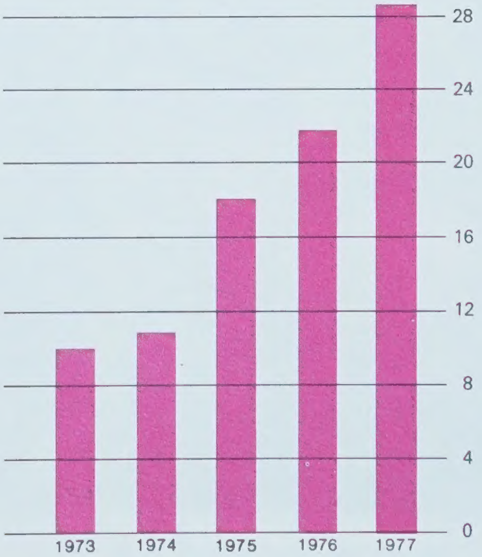
Total natural gas sales volume increased slightly to 16,972,000 Mcf in 1977 from 16,475,000 Mcf in 1976. Additional gas supply was contracted for during the year to service new customers and all gas supply contracts due for renewal were also successfully negotiated.

2,644 gas services and 200 miles of gas transmission and distribution mains were added to the system during the year and there are now 45,474 gas utility customers being serviced.

Kilowatt hours of electricity sold in the City of Yellowknife increased by 6.3% in 1977 and contributed $3,327,000 to revenues. 201 elec-

Loading of Company propane tank car

UTILITIES REVENUE
MILLIONS OF DOLLARS



trical services were added during the year and 2,976 customers are now being served.

Contribution to operating profits from gas and electric utility operations was $4,955,000 in 1977 compared to $4,776,000 in 1976.

THOMPSON PIPE AND STEEL COMPANY

Thompson Pipe, a wholly owned subsidiary, is a steel fabricator located in Denver, Colorado. Thompson provides engineered products for water, sewage, and hydro-electric projects. The company's manufacturing facilities include a new spiral weld pipe mill which is capable of manufacturing steel pipe to a diameter of ten feet. During 1977 the market for new major hydro-electric and water works projects declined substantially in the company's principal service area. Loss of sales and reduced gross margins together with increased costs attendant to the start-up of the new spiral mill produced an operating loss for 1977 of $336,000 compared with a contribution to operating profit in 1976 of $2,608,000.

Improvements in manufacturing methods and administrative changes have now been implemented. These include changes in senior management personnel, the consolidation of manufacturing facilities at a single location and the restructuring of the sales organization.

A 108" diameter pipe under construction at the Thompson Pipe Plant.

OIL AND GAS ACTIVITIES

The company's participation in oil and gas exploration and production is primarily achieved through its investment in Canadian Homestead Oils Ltd. In addition we carry out exploration and development activity in North Central Montana and in the South Nesson Anticline area of North Dakota.

At December 31, 1977 we had expended $14,370,000 under an Exploration Agreement with Homestead and had earned 2,441,589 of Homestead's common shares. These shares and the 629,900 shares owned by Castle Oil & Gas Limited, an 85% owned subsidiary of Hydrocarbons, give us an effective interest of 47% in the outstanding shares of Canadian Homestead. Under the Exploration Agreement with Homestead $3,842,000 remains to be expended in annual installments of not less than $1,500,000 or more than $3,070,000. At the conclusion of this Agreement, we will effectively own approximately 50% of Canadian Homestead.

Financial results for 1977 show that Homestead's gross revenue increased by 27% to a record high of $8,404,000 and funds provided from operations increased by 25% to $5,135,000. Net earnings of $3,174,000 were 51% higher than the preceding year.

During 1977 Homestead participated in 58 wells of which 44 were located in Alberta, 4 were in British Columbia, 2 in Saskatchewan and 8 in the state of Texas. Drilling activity resulted in 4 oil wells and 23 gas wells. Expenditures for the year included $6,500,000 for exploration and $1,500,000 for development of present reserves.

Gross proven reserves at December 31, 1977, excluding the Arctic Islands, totalled 189 billion cubic feet of natural gas and 10 million barrels of crude oil and natural gas liquids. Net reserves after royalties, excluding the Arctic Islands are 130 billion cubic feet of natural gas and 7½ million barrels of crude oil and natural gas liquids.

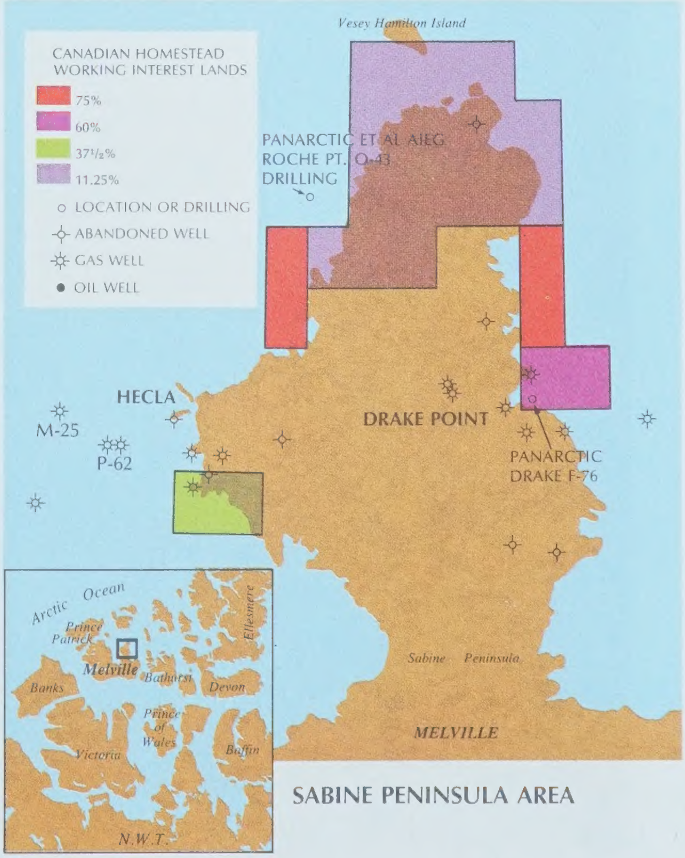
Land holdings at year-end totalled 13.4 million gross acres, 5 million net acres. A significant portion of this acreage is located in the Arctic Islands and Hudson Bay regions of Canada as well as in the province of Alberta.

Areas of current interest in which Homestead is participating include the following:

Pembina — The Pembina "deep drilling" play in north-central Alberta began over a year ago with the drilling of the discovery well which produced over 100,000 barrels of oil in the first three months of production. This discovery commenced drilling and geophysical activity which has been unsurpassed in the industry in Alberta for over a decade. Homestead's holdings in the area consist mainly of section 11-50-10-W5 which is wholly owned and the E½ of section 20-50-10-W5 in which a 25% interest is held. Extensive seismic programs have been conducted on these lands and it is expected that both parcels will be tested by drilling during 1978.

Cowpar Lake — In the Cowpar Lake region of northeastern Alberta, nine potential gas wells have now been drilled in the shallow McMurray Sands. Homestead has interests of from 50% to 100% in these wells and in 110,000 acres in the area. Other wells are planned to establish additional gas reserves.

Niteal — In the Niteal region of northeastern British Columbia, a one-third interest is held in 69,000 acres. Two wells drilled to date were

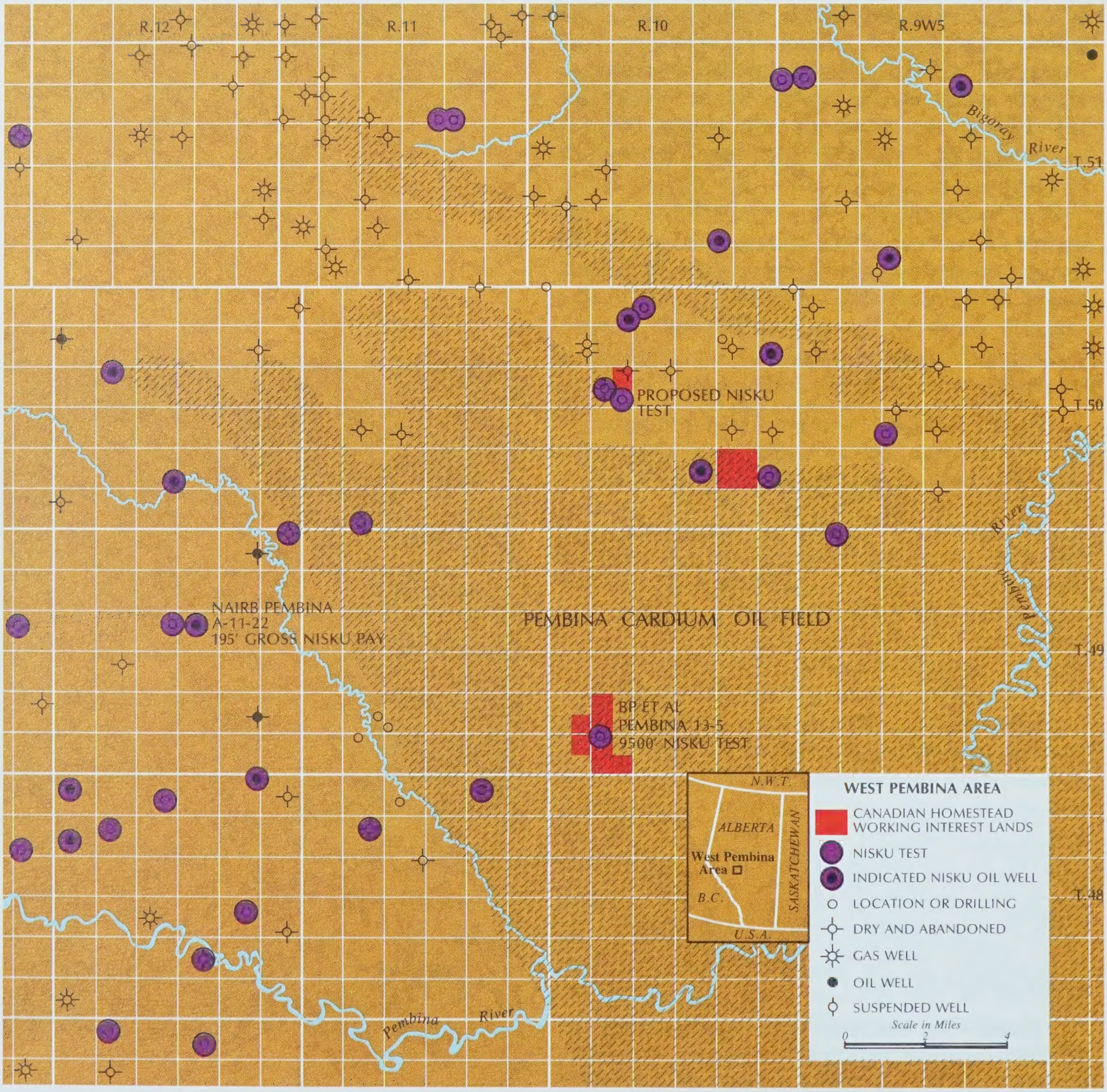


SABINE PENINSULA AREA

completed in the Mississippian zone and additional tests have been identified.

Arctic Islands — In 1976 a consortium of major oil companies committed to spend $80 million over a period of 4 to 6 years in exploration of 33 million acres located mainly in the waters between the islands of the western Arctic. An off-shore well currently being drilled is of particular interest to Canadian Homestead since it lies in close proximity to company owned lands encompassing 280,000 gross acres. Another off-shore well is soon to be drilled on Homestead's 60% owned Melville Island permit in the Drake Point Gas Field. It will be the first Arctic sub-sea completion conducted by the consortium. Plans call for the installation of the well-head and pipeline facilities connected to an on-shore gas liquefication plant. This project is of significance to Homestead in that, if successful, it could eventually make Homestead a beneficiary of the first gas sales from the Arctic Islands.

ON BEHALF OF
THE BOARD OF DIRECTORS



FIVE YEAR COMPARATIVE STATISTICS

(thousands of dollars except equity per share and shares outstanding)

	1977	1976	1975	1974	1973
Working capital	**$(3,591)**	$ 15,736	$ 19,893	$ 15,929	$ 20,470
Funds from operations (excluding depletion on limited term leases)	**13,461**	13,119	12,051	11,212	12,890
Purchase of fixed assets (net)	**9,404**	10,815	7,430	10,142	18,508
Fixed assets including cost of shares of subsidiaries over net book value	**117,013**	114,249	112,971	111,734	108,643
Long term debt	**54,404**	64,204	66,845	67,670	71,184
Preferred shares	**9,801**	9,972	10,144	10,307	10,475
Common shareholders' equity	**67,158**	62,308	57,194	47,770	42,835
Common shareholders' equity per share	**13.05**	12.15	11.15	9.31	8.35
Number of common shares outstanding at year-end (thousands)	**5,145**	5,130	5,130	5,130	5,130

EARNINGS PER SHARE AND COMMON STOCK PRICE RANGE

	Earnings Per Share		Common Stock Price Range (in dollars)			
	1977	1976	1977		1976	
Quarter			High	Low	High	Low
First	**$ .52**	$ .61	**8⅝**	**7⅜**	8¼	5⅝
Second	**.02**	(.01)	**9⅝**	**7⅝**	9½	7¼
Third	**.13**	.02	**10½**	**9¼**	10	7⅛
Fourth	**.37**	.31	**10⅞**	**9½**	8⅛	6⅜
Year ended	**$1.04**	$ .93				


WASH
MONTANA
N.
DAKOTA
OREGON
IDAHO
COLORADO
LOUISIANA

MAJOR FACILITIES AND DISTRIBUTION LOCATIONS

FRANCHISES	
Gas	121
Electrical	1
PROPANE AND PETROLEUM PRODUCT OUTLETS	
Retail Outlets	185
Consignee Operator Outlets	132
Storage Points	18
PROCESSING PLANTS AND REFINERIES	7
RAILWAY TANK CARS	198
HIGHWAY TRANSPORTS	
Propane — Tractors	21
— Trailers	60
Petroleum Products	8
DELIVERY TRUCKS	
Propane	304
Petroleum Products	17
SERVICE VEHICLES	597
EMPLOYEES	2,094
CUSTOMERS	
Propane & Utilities	248,823
MILES OF PIPELINE	
Transmission & Distribution	5,975
PROPANE STORAGE FACILITIES	
Above Ground	50,503,000
Under Ground	19,000,000

LEGEND

- ★ REFINERIES/PROCESSING PLANTS
- ● PROPANE
- ▲ GASOLINE
- ■ GASOLINE, LIGHT OILS, PROPANE
- ○ UTILITIES
- □ FOREST PRODUCTS
- △ METAL FABRICATING

CONSOLIDATED STATEMENT OF EARNINGS

For the years ended December 31, 1977 and 1976
(thousands of dollars)

	1977	1976
Operating Revenue		
Sales	**268,964**	256,067
Income from limited term oil and gas leases	**592**	2,770
Interest and other income	**3,389**	3,819
	272,945	262,656
Operating Expenses		
Cost of sales	**197,533**	187,490
Operating and maintenance	**48,003**	45,818
Depreciation and depletion	**8,180**	9,972
	253,716	243,280
Operating Profit	**19,229**	19,376
Equity in Net Earnings of Canadian Homestead Oils Limited	**1,310**	791
	20,539	20,167
Financial Expenses		
Interest on long-term debt	**5,038**	5,175
Other interest	**1,355**	1,263
Amortization of other assets	**239**	342
Loss (gain) on foreign exchange	**(159)**	8
	6,473	6,788
Earnings Before the following	**14,066**	13,379
Provision for Income Taxes	**6,417**	6,554
	7,649	6,825
Minority Interest in Earnings of Subsidiary Companies	**374**	320
Earnings for the Year from Continuing Operations	**7,275**	6,505
Discontinued Business (note 10)		
Loss from operations of discontinued business	**933**	1,164
Loss from disposal of discontinued business	**976**	—
	1,909	1,164
Earnings Before Extraordinary Item	**5,366**	5,341
Extraordinary Item		
Reduction of income taxes on application of prior years' losses	**570**	—
Net Earnings for the Year (note 11)	**5,936**	5,341

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

for the years ended December 31, 1977 and 1976
(thousands of dollars)

	1977	1976
Source of Funds		
Provided from operations	**13,962**	15,736
Disposal of fixed and other assets	**7,449**	1,493
Additional long-term debt	**283**	6,395
Contributions in aid of construction	**1,156**	1,864
Other	**632**	—
	23,482	25,488
Use of Funds		
Additions to fixed assets	**18,009**	14,171
Dividends on preferred and common shares	**1,859**	1,869
Reduction of long-term debt	**10,083**	9,149
Investment in Inter-City Gas Limited	**10,373**	—
Investment in Canadian Homestead Oils Limited	**1,504**	3,082
Redemption of first and second preferred shares	**171**	171
Additions to notes and mortgages	**750**	355
Customers' deposits	**—**	208
Other	**60**	640
	42,809	29,645
Decrease in working capital	**19,327**	4,157
Changes in working capital represented by		
Increase (decrease) in current assets -		
Cash and term deposits	**1,963**	(6,426)
Accounts and notes receivable	**(122)**	1,888
Inventories	**(464)**	2,363
Prepaid expenses	**(158)**	459
	1,219	(1,716)
Increase (decrease) in current liabilities -		
Bank loans	**12,160**	(2,728)
Accounts payable and accrued charges	**7,533**	4,552
Income taxes payable	**(1,869)**	(358)
Current maturities of long-term debt	**2,985**	379
Deferred income	**127**	119
Deferred income taxes	**(390)**	477
	20,546	2,441
Decrease in working capital	**19,327**	4,157
Working capital - beginning of year	**15,736**	19,893
Working capital (deficiency) - end of year	**(3,591)**	15,736

CANADIAN HYDROCARBONS LIMITED

CONSOLIDATED BALANCE SHEET
as at December 31, 1977 and 1976
(thousands of dollars)

ASSETS	1977	1976
Current Assets		
Cash	**5,107**	1,554
Short-term deposits	**5,973**	7,563
Accounts and notes receivable	**45,697**	45,819
Inventories (note 2)	**25,558**	26,022
Prepaid expenses	**1,109**	1,267
	83,444	82,225
Investments		
Shares of Inter-City Gas Limited (note 3)	**10,373**	—
Shares of Canadian Homestead Oils Limited (note 4)	**20,628**	18,002
Notes and other - at cost	**2,545**	2,307
	33,546	20,309
Fixed Assets (note 5)		
Cost	**168,818**	159,938
Accumulated depreciation and depletion	**55,495**	49,509
	113,323	110,429
Other Assets		
Debt financing and other deferred charges, less amortization	**893**	943
Cost of shares of subsidiaries over carrying value at dates of purchase	**3,690**	3,820
	4,583	4,763
	234,896	217,726

Signed on behalf of the Board:

H. G. Graham Director

Alan Greathouse Director

LIABILITIES	1977	1976
Current Liabilities		
Bank loans (note 7)	**31,050**	18,890
Accounts payable and accrued liabilities	**44,943**	37,410
Income taxes payable	**1,074**	2,943
Current portion of long-term debt	**8,315**	5,330
Deferred income	**1,566**	1,439
Deferred income taxes	**87**	477
	87,035	66,489
Long-Term Debt (note 6)	**54,404**	64,204
Provision for Future Costs on Discontinued Operations (note 10)	**1,642**	—
Customers' Deposits	**293**	291
Deferred Income Taxes	**9,175**	9,257
Minority Interest in Subsidiaries (note 8)	**5,388**	5,205
	70,902	78,957
	157,937	145,446
SHAREHOLDERS' EQUITY		
Capital Stock (note 9)		
Authorized -		
250,000 5½% cumulative redeemable first preferred shares, par value $20		
4,000,000 6% cumulative redeemable second preferred shares, par value $25		
14,000,000 common shares, no par value		
Issued and fully paid -		
204,055 first preferred shares (1976 - 207,755 shares)	**4,081**	4,155
228,800 second preferred shares (1976 - 232,700 shares)	**5,720**	5,817
5,144,918 common shares (1976 - 5,129,680 shares)	**24,356**	24,236
	34,157	34,208
Contributions in Aid of Construction	**11,831**	10,949
Retained Earnings	**30,971**	27,123
	76,959	72,280
	234,896	217,726

CONSOLIDATED STATEMENT OF RETAINED EARNINGS

for the years ended December 31, 1977 and 1976
(thousands of dollars)

	1977	1976
Balance - Beginning of Year		
as previously reported	**27,123**	24,134
Less: Draw-downs of deferred income taxes	**229**	483
As restated	**26,894**	23,651
Net earnings for the year	**5,936**	5,341
	32,830	28,992
Dividends -		
Preferred shares	**575**	587
Common shares	**1,284**	1,282
	1,859	1,869
Balance - End of Year	**30,971**	27,123

AUDITORS' REPORT

To the Shareholders

We have examined the consolidated balance sheet of Canadian Hydrocarbons Limited as at December 31, 1977 and the consolidated statements of earnings, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at December 31, 1977 and the results of its operations and the changes in its financial position for the year then ended, in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Winnipeg, Manitoba
April 12, 1978

Coopers & Lybrand
Chartered Accountants

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

for the years ended December 31, 1977 and 1976

1. Significant accounting policies

Basis of consolidation -

The consolidated financial statements include the accounts of Canadian Hydrocarbons Limited and its subsidiary companies and reflect earnings of subsidiaries since acquisition. The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Canada which differ in certain respects with accounting principles in the United States. These differences are described further in the company's annual report on Form 10-K filed with the Securities and Exchange Commission.

Foreign currency translation -

Amounts in foreign currency have been translated into Canadian dollars on the following basis: current assets and current liabilities at the rate of exchange in effect at the balance sheet date; non-current assets and long-term liabilities at the rate of exchange when the asset was acquired or the liability incurred; revenue and expenses at the average rate for the year. Gains or losses on translations are charged to earnings.

Business combinations -

All companies acquired have been accounted for as purchase acquisitions. Purchase prices have been allocated to assets based on appraisals and any remaining difference is recorded as "cost of shares of subsidiaries over carrying value at dates of purchase".

Inventories -

Inventories of propane and other petroleum products are valued at the lower of cost (first-in, first-out) and replacement cost except for certain United States' subsidiaries which price these inventories on the last-in, first-out method. Inventories of merchandise, materials and supplies are valued at the lower of cost (first-in, first-out) and net realizable value.

Investments -

The company accounts for its investment in Canadian Homestead Oils Limited by the equity method and for its investment in Inter-City Gas Limited by the cost method.

Fixed assets, depreciation and depletion -

Fixed assets are recorded at cost, which policy includes the full cost method of accounting for oil and gas properties. Depreciation is provided on a straight line basis at rates varying from 2% to 25% which are designed to amortize the cost of the assets over their estimated useful lives. Amortization of contributions in aid of construction is provided in amounts that correspond with depreciation of the related assets.

Oil and gas properties and royalty interests are depleted on a unit of production method based on estimated remaining reserves. Limited term interests in oil and gas leases are depleted over their remaining terms.

Debt financing and other deferred charges -

Amortization of financing expenses is provided on a straight line method over the terms of the issues and amortization of deferred charges is provided on a straight line method over periods of five years to twenty years.

Income taxes -

Since 1969 the company, with the exception of its public utility subsidiaries, has accounted for income taxes by the tax allocation method whereby the income tax provision is based on the earnings reported in the accounts. Unrecorded deferred income taxes at 1969 are charged to retained earnings as draw-downs occur. Public utility subsidiaries record only income taxes payable in accordance with regulatory requirements. At December 31, 1977 unrecorded deferred income taxes with respect to such subsidiaries amounted to approximately $1,884,000; (1976 - $1,733,000).

2. Inventories

Inventories are classified as follows:

	1977	1976
	(Thousands of Dollars)	
Propane and other petroleum products	**7,048**	8,845
Merchandise, materials and supplies	**18,510**	17,177
	25,558	26,022

If inventories in the United States whose cost was determined on the last-in, first-out method were instead valued on a first-in, first-out method, the inventories would be increased by approximately $2,597,000 in 1977 and $2,313,000 in 1976. The effect of using the last-in, first-out method was to increase net earnings by $481,000 in 1977 and by $50,000 in 1976.

3. Investment in Inter-City Gas Limited

On December 30, 1977 the company purchased 1,037,250 common shares of Inter-City Gas Limited for a price of $10.00 per share. The purchase was by way of a cash payment of $2,593,125 and by way of a promissory note, carrying an interest rate of 1½% above bank prime rate, for $7,779,375 payable in three consecutive quarterly instalments commencing March 31, 1978. Inter-City Gas Limited owns approximately 49% of the outstanding common shares of the company.

In January 1978, Inter-City Gas Limited granted and the company accepted, an option to purchase all or any part of a further 2,300,000 common shares of Inter-City Gas Limited at a price of $11.00 per share. The option is exercisable at any time during the period ending December 29, 1978.

If the option is exercised the company will increase its shareholdings in Inter-City Gas Limited to approximately 51% (diluted to 46% after exercise of all the outstanding warrants to purchase shares in Inter-City Gas Limited).

In May 1977 Inter-City Gas Limited announced a proposed exchange offer to the shareholders of the company whereby it would exchange one and one-half common shares of Inter-City Gas Limited for each common share of Canadian Hydrocarbons Limited. This exchange offer is pending subject to the approval of the Securities and Exchange Commission, Washington and Securities Commissions in Canada.

4. Investment in Canadian Homestead Oils Limited

Under the terms of agreements between Canadian Propane Gas & Oil Ltd. (Canadian Propane), a wholly-owned subsidiary, and Canadian Homestead Oils Limited (Canadian Homestead), Canadian Propane is committed to expenditures of $18,212,000 and will receive, as consideration, 3,018,201 shares in Canadian Homestead.

Canadian Propane is required to expend annually a minimum of $1,500,000 but not more than $3,070,000 until the full commitment has been met. Total expenditures to December 31, 1977 were $14,370,000 which has earned Canadian Propane a total of 2,441,589 common shares of Canadian Homestead of which 2,333,363 shares have been issued to date.

The company owns 83.5% of Castle Oil and Gas Limited which holds 629,900 of the outstanding common shares of Canadian Homestead.

For accounting purposes, the company has computed its equity income in Canadian Homestead based on its effective interest of 47%. This interest has a quoted value of approximately $33,600,000 at December 31, 1977.

5. Fixed Assets

Fixed assets are classified as follows:

	1977	1976
	(Thousands of Dollars)	
Customers' installations	**34,152**	32,770
Transmission lines and distribution systems	**44,357**	40,349
Buildings and equipment	**36,832**	39,438
Refineries and gas plants	**14,336**	11,604
Automotive equipment	**12,796**	11,605
Oil, gas and mining properties and equipment	**12,225**	9,968
Oil and gas royalties	**7,099**	7,099
Limited term oil and gas leases	**2,001**	2,001
Land	**5,020**	5,104
	168,818	159,938
Less:		
Accumulated depreciation	**46,423**	41,884
Accumulated depletion	**9,072**	7,625
	55,495	49,509
	113,323	110,429

6. Long-Term Debt

The details of long-term debt are as follows:

	1977	1976
	(Thousands of Dollars)	
Parent		
7% promissory note, due 1981	**1,364**	1,706
9% promissory note, due 1983	**2,850**	3,325

Subsidiaries		
9¼% to 9½% bank loans, due on various dates to 1981 (U.S. - $4,500)	**4,929**	6,515
5% to 9% promissory notes, due 1978 and 1980 (U.S. - $2,943)	**3,062**	3,266
6% to 6½% sinking fund debentures, due on various dates from 1981 to 1985	**8,375**	8,979
6½% sinking fund debentures, due 1987 (U.S. - $2,523)	**2,533**	2,632
7¼% promissory note, due 1989 (U.S. - $3,600)	**3,608**	3,680
5% subordinated debentures, due 1989 (U.S. - $3,862)	**3,889**	4,091
10½% promissory note, due 1996 (U.S. - $3,000)	**2,962**	2,959
10¾% promissory note, due 1995	**2,970**	3,000
5% subordinated note, due 1990 (U.S. - $4,075)	**4,110**	4,389
9⅝% sinking fund debentures, due 1978 to 1991 (U.S. - $6,720)	**6,746**	7,000
8⅝% promissory notes, due 1993	**4,365**	4,410
8¾% to 8.98% bank production loans, due on various dates to 1981	**8,840**	9,995
Notes and mortgages, due on various dates	**2,116**	3,587
	62,719	69,534
Less: Current portion included in current liabilities	**8,315**	5,330
	54,404	64,204

Long-term debt repayments, including estimated bank production loan repayments, in each of the five years subsequent to December 31, 1977 are as follows:

	(Thousands of Dollars)
1978	8,315
1979	5,274
1980	4,437
1981	10,600
1982	2,499

Long-term debt issues repayable in United States funds are included above at their Canadian dollar equivalent ($34,184 in 1977 and $41,279 in 1976) at the respective dates of issue except for current maturities which are translated at year-end rates. If long-term debt payable in United States funds was translated at exchange rates in effect at year end it would result in an increase in long-term debt of $3,075 at December 31, 1977 ($334 at December 31, 1976).

7. Security for Bank Loans

Certain fixed and current assets have been pledged as security for bank loans amounting to $29,390,000.

8. Minority Interest in Subsidiaries

	1977	1976
	(Thousands of Dollars)	
Preferred shares of Great Northern Gas Utilities Ltd.	**2,195**	2,251
Equity Interest in -		
Fort St. John Petroleums Ltd. and its subsidiary	**2,421**	2,225
Castle Oil and Gas Limited	**772**	729
	5,388	5,205

9. Capital Stock

Under the provisions relating to the outstanding preferred shares, the company is required to purchase annually for redemption 3,500 first preferred shares and 3,900 second preferred shares, if available on the open

market, at prices not exceeding their par value. In addition, the first and second preferred shares are redeemable by the company at any time at prices not exceeding $21.10 and $26.50 per share respectively.

To December 31, 1977, the company has redeemed 45,945 first preferred shares of an aggregate par value of $918,900 and 31,200 second preferred shares of an aggregate par value of $780,000. Under provisions of the Canada Corporations Act, consolidated retained earnings includes $1,699,000 designated as "capital surplus".

Under stock option plans adopted in prior years, the company may grant options to officers and employees to purchase common shares. Generally, options are exercisable cumulatively at the rate of 25% annually beginning one year from date of granting and expiring five years from such date.

	Price per share	Shares optioned
1976		
Options outstanding - beginning of year	$7.50 to $10.00	86,325
Options granted	$8.375	5,000
Options cancelled	$7.50 to $8.00	(32,000)
Options outstanding - end of year	$7.50 to $10.00	59,325
1977		
Options granted	Nil	Nil
Options exercised	$7.50 to $8.00	(15,238)
Options cancelled	$7.50 to $8.00	(6,900)
Options outstanding - end of year	$7.50 to $10.00	37,187

At December 31, 1977 183,513 common shares were reserved for the granting of options in the future under the Stock Option Plan.

10. Discontinued Business

On November 1, 1977 the manufacturing assets of the company's forest products division in Oregon, consisting of a plywood fabricating facility and veneer mill, were sold for an amount of $6,658,926 (U.S.). On February 28, 1978 the company decided to terminate its remaining interest in the business of that division.

The operating loss for the year ended December 31, 1977 of $933,000 after applicable income taxes, includes the loss on sale of the manufacturing assets of $57,675 (net of income taxes). The operating loss for the year ended December 31, 1976 of $1,164,000 included an amount of $1,350,000 relating to the write-off of the excess cost of shares over the recorded carrying value of the division's net assets at the date of purchase. The amount of sales and cost of sales eliminated from the consolidated statement of earnings for the respective years was as follows:

	1977	1976
	(Thousands of Dollars)	
Sales	**96,415**	66,400
Cost of sales	**92,674**	62,753

A provision of $1,642,000 ($976,000 after tax) has been made for the estimated expenses and write-offs including disposal of the remaining property, plant and equipment, estimated losses on the realization of inventories, future close-down costs and other costs relating to this decision.

11. Earnings per Common Share

	1977 $	1976 $
From continuing operations before discontinued operations and extraordinary item -		
Basic	**1.30**	1.15
Fully diluted	**1.30**	1.14
Including discontinued operations and extraordinary item -		
Basic	**1.04**	0.93
Fully diluted	**1.04**	0.92

12. Remuneration of Directors and Officers

During the year the company had eight directors and seven officers (1976 - twenty directors and eleven officers) who received the following remuneration:

	As directors		As officers	
	1977	1976	1977	1976
	(Thousands of Dollars)		(Thousands of Dollars)	
From the company	**19**	39	**191**	306
From subsidiaries	**—**	4	**110**	77
	19	43	**301**	383

13. Commitments and Contingencies

In addition to the commitment outlined in note 4, the company has entered into long-term contracts to lease certain assets at annual rentals of approximately $1,232,000 expiring over terms of up to eighteen years from December 31, 1977.

In the year 1971, the company treated the cost of acquiring limited term interests in oil and gas leases as a deduction from income, with the intention that the income therefrom in subsequent years would be treated as taxable. The income tax authorities have indicated, through tax reassessments for the year 1971, that the acquisition costs are capital payments, are not deductible from income and the income therefrom is repayment of capital. In the event that all years subsequent to 1971 are also reassessed on a similar basis the total estimated liability at December 31, 1977 for unpaid taxes, including interest penalties amounts to $3,271,000.

The company has filed Notices of Appeal to the reassessments. If the appeals are unsuccessful approximately $2,916,000 will be charged to earnings as follows:

	(Thousands of Dollars)
1977	190
1976	559
Prior to 1976	2,167

The remaining $355,000 will be a draw-down of deferred income taxes. In view of these appeals no liability for the $2,916,000 has been provided and the company has arranged for a letter of guarantee to be issued by a bank to Revenue Canada for the amount of the reassessment.

14. Anti-Inflation Act

Under the Federal Government's Anti-Inflation program the company is subject to mandatory compliance with legislation which controls prices, profit margins, employee compensation and shareholder dividends. Petroleum and natural gas prices which are subject to the Petroleum Administration Act and utility revenues which are subject to rulings by a provincial regulatory agency are exempt from the application of this program. The company is in compliance with the legislation in all material respects.

15. Comparative Figures

The comparative figures for 1976 were reported on by other auditors and in certain cases have been reclassified to conform with the current year's financial statement presentation. In 1976 net earnings were increased by approximately $470,000, as the company commenced to accrue certain amounts receivable under a United States government program designed to average the cost of crude oil purchased by refineries.

16. Replacement Cost (Unaudited)

In compliance with rules of the Securities and Exchange Commission, the company has estimated replacement cost information for inventories, certain fixed assets, cost of sales and depreciation. Information on replacement cost is disclosed in the company's annual report on Form 10-K filed with the Securities and Exchange Commission.

17. Quarterly Financial Data (Unaudited)

Summarized quarterly financial data (in thousands of dollars except for per share amounts) for the year 1977 is as follows:

	Three months ended			
	March 31,	June 30,	September 30,	December 31,
Net sales	71,016	58,891	59,285	79,772
Gross profit	18,861	14,714	15,453	22,403
Net earnings	2,793	252	816	2,075
Net earnings per common share	.52	.02	.13	.37

The net sales and gross profit are stated after eliminating the operations of the discontinued business.

CANADIAN HYDROCARBONS LIMITED and subsidiaries

FIVE YEAR SUMMARY OF OPERATIONS

SUMMARY OF CONSOLIDATED STATEMENTS OF EARNINGS

for the years ended December 31
(in thousands of dollars, except where amounts are given on a per share basis)

	1977	1976	1975	1974	1973
OPERATING REVENUE	**$272,945**	$262,656	$256,360	$211,354	$138,342
OPERATING EXPENSES					
Cost of sales	**197,533**	187,490	183,552	144,117	82,281
Operating and maintenance	**48,003**	45,818	40,757	35,135	26,056
Depreciation and depletion	**8,180**	9,972	10,770	12,415	15,382
	253,716	243,280	235,079	191,667	123,719
OPERATING PROFIT	**19,229**	19,376	21,281	19,687	14,623
EQUITY IN NET EARNINGS OF CANADIAN HOMESTEAD OILS LIMITED	**1,310**	791	661	(38)	(328)
	20,539	20,167	21,942	19,649	14,295
FINANCIAL EXPENSES					
Interest on long-term debt	**5,038**	5,175	5,204	4,921	4,292
Other interest	**1,355**	1,263	1,496	1,845	802
Amortization of other assets	**239**	342	364	288	307
Loss (gain) on foreign exchange	**(159)**	8	—	—	—
	6,473	6,788	7,064	7,054	5,401
EARNINGS BEFORE THE FOLLOWING:	**14,066**	13,379	14,878	12,595	8,894
PROVISION FOR INCOME TAXES	**6,417**	6,554	7,387	7,058	4,981
	7,649	6,825	7,491	5,537	3,913
MINORITY INTEREST IN EARNINGS OF SUBSIDIARY COMPANIES	**374**	320	294	329	272
EARNINGS FOR THE YEAR FROM CONTINUING OPERATIONS	**7,275**	6,505	7,197	5,208	3,641
DISCONTINUED BUSINESS (note 10)					
Loss from operations of discontinued business	**933**	1,164	337	327	—
Loss from disposal of discontinued business	**976**	—	—	—	—
	1,909	1,164	337	327	—
EARNINGS BEFORE EXTRAORDINARY ITEM	**5,366**	5,341	6,860	4,881	3,641
EXTRAORDINARY ITEM					
Reduction of income taxes on application of prior years' losses	**570**	—	—	—	—
NET EARNINGS FOR THE YEAR (note 11)	**5,936**	5,341	6,860	4,881	3,641
Dividends on preferred shares	**575**	587	595	605	614
	$ 5,361	$ 4,754	$ 6,265	$ 4,276	$ 3,027
PER SHARE INFORMATION					
Earnings per common share	**$ 1.04**	$ .93	$ 1.22	$ .83	$ .60
Dividends per common share	**.25**	.25	.25	.25	.25
REVENUE BY LINES OF BUSINESS					
Gasoline and other petroleum products	**$117,580**	$109,599	$107,362	$ 81,044	$ 55,515
Propane	**87,994**	78,194	78,019	68,424	39,463
Natural gas and electricity	**30,360**	23,474	17,575	12,548	11,177
Merchandise and other sales	**20,510**	30,452	29,843	27,264	20,326
Steel product sales	**15,441**	17,201	17,743	13,917	—
Income from limited term oil and gas leases	**592**	2,770	4,428	5,897	9,975
Other income	**468**	966	1,390	2,260	1,886
	$272,945	$262,656	$256,360	$211,354	$138,342

Note: The information gives retroactive effect to income tax re-assessments, equity in net earnings of affiliate, tax allocation adjustments and operations of a discontinued business.

CANADIAN HYDROCARBONS LIMITED

MANAGEMENT DISCUSSION AND ANALYSIS OF SUMMARY OF OPERATIONS

1976 Compared to 1975

1. In February of 1978, management made a decision to discontinue the operations of the forest products division. The consolidated statement of earnings has been adjusted retroactively to exclude the operations of the discontinued business from the various categories of revenue and expense, and the net results of the division are shown as a loss from operations of a discontinued business.
2. Revenue increased by $6.3 million 2.5% over 1975. Revenues in the utility division provided the major portion of this modest increase. Additional customers and small volume increases were the reasons for the increase in revenue. Modest price increases in propane, gasoline and other petroleum products were substantially offset by decreased sales volumes.
3. Cost of sales increased by $3.9 million, 2.1% over 1975. Increased cost of natural gas reflecting higher well-head prices account for the major part of this increase.
4. Operating, selling and administrative expenses increased by $5.0 million, 12.3% over 1975. The expense of an extensive cost control program and unusual bad debt experience during the year substantially account for that part of the increase in excess of inflationary escalation.
5. The loss from operations of discontinued business increased by $826,000 over 1975. This increase includes $1.3 million being the amortized balance of "excess of cost over net book value of assets acquired", recorded at the date of purchase by Gold Rey Forest Products Inc. In view of the accumulated losses realized in the forest products division since acquisition, this excess cost, generally recorded in anticipation that future earnings will justify such value, was written off during 1976.

1977 Compared to 1976

1. Because of continuing operating losses, management made the decision in February of 1978 to discontinue the operations of the forest products division and a loss provision of $1.6 million ($976,000 after tax) has been recorded in the accounts at December 31, 1977. This adjustment together with a net loss from operations of $933,000 for the year has reduced earnings per common share of the registrant by 37 cents. The statement of earnings has been adjusted retroactively to exclude the operations of the discontinued business from the various categories of revenue and expense, and the net results of the division are shown as a loss from operations of a discontinued business.
2. Revenues increased by $10.3 million, 3.9% over 1976. Additional revenues in the utility and petroleum products divisions, resulting from rate increases permitted by governmental regulatory agencies, account for the major portion of the increase. A decline in the sales of steel pipe, largely because of decreased demand for irrigation and water system pipe, and reduced revenues from limited term oil and gas leases, partially offset the increased revenues of the other divisions.
3. Cost of sales increased by $10.0 million, 5.4% over 1976. The major contributing factor is the increased prices paid by the utility division for natural gas. Also reflected in the cost of sales increase are cost over-runs, which occurred in the steel products division. These over-runs were associated with the installation of a new spiral pipe mill.
4. Operating, selling and administrative expenses have increased by $2.2 million, 4.8% over 1976. Increases in salary costs, operating facility maintenance costs, truck fleet operation expenses and insurance rates resulted in the increases reflected in this expense classification.
5. Depreciation and depletion declined by $1.8 million, 18.0% less than 1976, due to the significant retirement of limited term oil and gas leases. The retirement creates a reduction of a similar amount in revenue as mentioned above.

CANADIAN HYDROCARBONS LIMITED

DIRECTORS

G. R.

George R. Chater
Toronto, Ontario
President
Grafton Group

Henry E. Dynes
Toronto, Ontario
Chairman & Chief Executive Officer
Traders Group Limited

Robert G. Graham
Winnipeg, Manitoba
President and Chief Executive Officer
Inter-City Gas Limited

James W. McCutcheon, Q.C.
Toronto, Ontario
Senior Partner
Shibley, Righton & McCutcheon

Gordon P. Osler
Toronto, Ontario
Vice Chairman and Chief Executive Officer
British Steel Corporation (Canada) Limited

George C. Solomon
Regina, Saskatchewan
President
Western Tractor Ltd.

Alan Sweatman, Q.C.
Winnipeg, Manitoba
Senior Partner
Thompson, Dorfman, Sweatman

Michael J. Walton
Vancouver, British Columbia
Executive

OFFICERS

Robert G. Graham
Chairman of the Board and President

Anthony C. Rooney
Vice President Finance

Wayne R. Harding
Vice President

C. Roy Beenham
Vice President

W. Robert Loren
Vice President

John E. Carstairs
Secretary and Counsel

Allan E. Dobson
Assistant Secretary and
Corporate Controller

CORPORATE INFORMATION

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Inter-City Gas Building
444 St. Mary Ave.
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Transfer Agent and Registrar
Montreal Trust Company, Calgary,
Toronto and Montreal

United States Transfer Agent
Morgan Guaranty Trust Company
of New York, New York

United States Registrar
Manufacturers Hanover Trust Company,
New York

Stock Exchange Listings
Canada
Toronto Stock Exchange
Montreal Stock Exchange

United States
American Stock Exchange

Solicitors
Thompson, Dorfman, Sweatman

Auditors
Coopers & Lybrand